Office of Chief Counsel
Internal Revenue Service

memorandum

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JWDuncan

date: APR 15 2002

to: [redacted], Manager, Group [redacted]
Attn: International Examiner [redacted]

from: Office of Chief Counsel
LMSB (Natural Resources), Area 4, Phoenix

subject: [redacted] **Corporation**
Withholding Agent in [redacted], Inc. Transaction

This memorandum responds to your request for assistance of March 25, 2002. This memorandum should not be cited as precedent.

ISSUES

1. Whether payment of interest on the $[redacted] loan described below is subject to withholding pursuant to I.R.C. § 1442.

2. Whether the withholding agent for such loan was [redacted], Inc. ([redacted]), which was obligated to repay the loan, or [redacted] Corp. ([redacted]), which actually made the payment.

3. Whether the withholding agent knew or had reason to know of its duty to withhold.

CONCLUSIONS

1. This series of transactions appears to involve a conduit financing arrangement, and thus requires withholding.

2. Because [redacted] paid the amounts at issue, it is the withholding agent.

3. It is possible that [redacted] did not know and had no reason to know of its duty to withhold; more facts are required to make this determination.

FACTS

[redacted] Ltd. ([redacted]) is a [redacted] Corporation, and is the wholly-owned subsidiary of [redacted] Bank ([redacted]),

a [redacted] corporation. During [redacted], [redacted] formed and owned [redacted]% of the stock of [redacted], a U.S. corporation. Numerous individuals and entities held the remaining [redacted]% of [redacted] stock.

In [redacted], [redacted] purchased an [redacted]% interest in [redacted], LLC ([redacted]), a domestic corporation which had elected to be taxed as a partnership. In spite of the name similarities, [redacted] and [redacted] were totally unrelated prior to this transaction; it appears that [redacted] was actually formed for the sole purpose of acquiring [redacted]. [redacted] agreed to pay $[redacted] for this [redacted]% interest in [redacted].

[redacted] purportedly obtained $[redacted] of the purchase price in the form of a mezzanine loan from [redacted] ([redacted]), an [redacted] corporation, which was a wholly-owned subsidiary of [redacted]. You have discovered that [redacted] did not give such funds to [redacted]. Instead, this $[redacted], along with other funds used to purchase the [redacted]% interest in [redacted], came directly from [redacted]'s account #[redacted] at [redacted] Bank.

In [redacted], the [redacted] Corporation ([redacted]), a domestic corporation, purchased a 100% interest in [redacted], which of course included [redacted]'s entire [redacted]% interest. At closing, and as part of the purchase agreement, [redacted] paid off the above-described mezzanine loan, which at that point had a principal balance of the original $[redacted], and accrued interest of $[redacted] [redacted] paid this amount by electronic transfer to the above-referenced account of [redacted] at [redacted] Bank.

The taxpayer believes that no withholding under I.R.C. § 1442 was necessary for the payment of interest on the $[redacted] loan due to the U.S. treaty with [redacted], home of [redacted]. You believe that the loan may have actually come from [redacted] rather than [redacted], which would require withholding at the rate of [redacted]% due to the lack of a similar treaty with [redacted]. You are also concerned with who might be the correct withholding agent for this transaction, since the loan at issue was the liability of [redacted] rather than [redacted]. We want to note that the above statement of facts does not fully describe all activity during the relevant periods regarding the [redacted] line of products. We nonetheless believe that it includes all facts relevant to these particular issues.

DISCUSSION

1. I.R.C § 881(a)(1) generally imposes a 30% tax on interest received by foreign corporations from sources within the United States.

I.R.C. § 1442(a) requires that taxes imposed on foreign corporations be deducted and withheld at the source of the income in the same manner and on the same items of income as is provided in I.R.C. § 1441. Section 1441 in turn requires such withholding from several enumerated types of income, including interest, and at the rate of 30%.

As mentioned above, if in fact the $[redacted] mezzanine loan came from [redacted], and [redacted] made payment on such loan to [redacted], then the payment of interest on the loan would be exempt from withholding due to the treaty between [redacted] and the U.S. Therefore, in order for § 1442 to require withholding, the Service must demonstrate that the loan was not from, and/or payments thereunder were not to, [redacted], but instead related to an entity not exempt by treaty from withholding.

In that regard, you have suggested that Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971) provides a rule under which the Service can ignore the form of such a transaction. In Aiken, the taxpayer, a U.S. corporation, owned a subsidiary, also a U.S. corporation, which borrowed funds from the taxpayer's Bahamian parent. An Equadorian subsidiary of the Bahamian parent formed a subsidiary in Honduras. The Bahamian parent then exchanged the notes of the taxpayer's subsidiary to the new Honduras entity for its debt, which matched the principal amount and interest rate of the debt received. As you might expect, the taxpayer was required to withhold at the rate of 30% on payments of interest to a Bahamian company, but was not required to withhold on payments to Honduran entities due to a treaty. The court determined that the taxpayer was not protected by the U.S-Honduran treaty, determining that the interest payments were not actually received by the Honduran corporation, but instead were received by the Bahamian parent, due to the lack of business purpose behind the "mere exchange of paper."

Since the Aikens decision, the Service has promulgated regulations regarding conduit financing transactions pursuant to authority granted in I.R.C. § 7701(l). See Treas. Reg. §§ 1.881-3 and 4. These regulations allow the Service to disregard for purposes of § 881 the participation of one or more intermediate entities in a financing arrangement where such entities are acting as mere conduits. A conduit entity is one 1) whose participation reduces the tax imposed by § 881, 2) whose participation is pursuant to a tax avoidance plan, and 3) who is related to the financing or financed entity (or meets certain other standards not relevant to this discussion). The first and third are clearly present in this situation, leaving only the question of whether [redacted] participation was due to a tax-avoidance plan.

To assist in this determination, the regulations under I.R.C. § 881 define "tax avoidance plan" as a plan in which one of the principle purposes is the avoidance of tax imposed by § 881. The only purposes relevant to this determination are those relating to the intermediate entity's participation in the financing arrangement, and not those relating to the existence of the financing arrangement as a whole. Treas. Reg. § 1.881-3(b)(1). The regulations provide four factors to aid in determining whether an intermediate entity's participation in a financing arrangement is pursuant to a tax-avoidance plan. The fourth deals with the relationship of the primary parties, and does not apply here. The other three, however, tend to indicate a tax avoidance purpose for this transaction. They are:

a. Whether the intermediate entity's participation in the financing arrangement significantly reduced the tax that otherwise would have been imposed under § 881. If [redacted] had made the loan directly, interest on the loan would have been taxed at [redacted]% instead of at [redacted]%.

b. Whether the intermediate entity would have been able to make the advance of the money to the financed entity without the financing entity's advance of money. While we strongly recommend that you investigate [redacted] ability to provide such funds without the assistance of [redacted], we believe that [redacted]'s direct payment of such funds to [redacted] is an indication that [redacted] may not be able to meet this test.

c. The length of time separating the financing entity's advances of money to the intermediate entity and the intermediate entity's advances to the financed entity. In the present case, [redacted] bypassed [redacted] altogether, providing the Service with an extremely strong indicator of a purpose to avoid tax under § 881.

In such a situation, Treas. Reg. § 1.1441-3(j) generally requires withholding at the rate applicable if the intermediate entity is disregarded.

To summarize, although we believe that [redacted] was likely a conduit entity, and that the treaty with [redacted] therefore does not insulate this transaction from tax, we recommend that the Service further develop the second factor in Treas. Reg. § 1.881-3(b)(2) regarding whether a tax avoidance purpose existed, [redacted], (b)(5)(AC), (b)(5)(AWP)

2. I.R.C. § 1442(a) states that the tax on payments such as the one at issue "shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in

section 1441 ... ." Section 1441(a) states that with certain exceptions, all persons "having the control, receipt, custody, disposal or payment" of certain income items must deduct and withhold the subject tax. The withholding agent is generally the last person to have control, receipt, custody, or disposal of the income item before payment to the foreign person subject to U.S. income tax liability. In the present case, such "person" was [redacted].

You have nonetheless asked whether [redacted] might also be considered a withholding agent in this situation, especially since it was [redacted]'s debt that [redacted] paid. We view this as extremely unlikely, since [redacted] did not have "control, receipt, custody, or disposal" of the funds [redacted] used as payment of [redacted]'s loan. Indeed, we understand that [redacted]'s agreement to pay off the loan was with [redacted]'s shareholders, not [redacted] itself; to the extent that someone not handling the money might be able to "control" the money through contract provisions, that did not occur here. We acknowledge that it is possible for a party not apparently involved to be a withholding agent. For example, in Casa De La Jolla Park, Inc. v. Commissioner, 94 T.C. 384 (1990), the U.S. borrower arranged for a U.S. bank to collect on certain debts to borrower, and to use these funds to pay such amounts to its foreign lender. Under such circumstances, the court found that the U.S. borrower had sufficient control over the funds to trigger a duty to withhold, even though the U.S. borrower did not actually make the payment to the foreign lender. This situation differs from the present case in two significant ways. First unlike Casa De La Jolla, [redacted] had no right to or control over the funds used to pay the foreign lender. See Tonopah & T.R. Co. v. Commissioner, 112 F.2d 970 (9th Cir. 1940). Second, we are aware of no evidence that [redacted] negotiated or was responsible for the arrangement under which [redacted] paid off the loan. We therefore believe that [redacted] was not a withholding agent for this payment, and that instead, [redacted] is the withholding agent liable under § 1442.

3. Treas. Reg. § 1.1441-7(f)(2) provides that a withholding agent will not be liable for failing to deduct and withhold with respect to a conduit financing arrangement "unless the person knows or has reason to know that the financing arrangement is a conduit financing arrangement." This regulation further provides that this standard will be satisfied if the withholding agent knows or has reason to know "facts sufficient to establish that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan." A withholding agent that only knows of the financing transactions that comprise

the financing arrangement will not be considered to know or have reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement.

In the present case, we are unaware of exactly what [redacted] knew or had reason to know at the time it transferred funds to [redacted]'s account at [redacted] Bank. In order to make such a determination, [redacted]

[redacted]

To summarize this discussion, we believe that [redacted] is the withholding agent for the interest portion of its payment of [redacted]'s loan, and that such loan was part of a conduit financing arrangement, so that the withholding amount would be determined as if the payments were made to a [redacted] entity. The Service, however, must be able to demonstrate that [redacted] knew or had reason to know of the conduit financing arrangement if it intends to raise this issue.

Please be advised that we consider the statements of law expressed in this memorandum to be significant large case advice. We therefore request that you refrain from acting on this memorandum for ten (10) working days to allow for appropriate national office post-review. If you have any questions regarding the above, please contact the undersigned at (602) 207-8052.

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JOHN W. DUNCAN
Attorney